CHAPTER

2

THE THEORY AND PRACTICE OF MARKET CAPITALISM

All the bad things you hear about markets are true: unemployment, inflation, inequalities of income and wealth, monopoly power, negative externalities, and insufficiently supplied public goods. You know, there is only one thing that is worse than the market, and that is no market.

Csaba Csaki, Rector of Economics, University of Budapest (formerly Karl Marx University), August 1990.

Introduction

The vast changes sweeping through the world economy have focused attention upon the nature of the market capitalist economic system, the system that is the goal of many reformers in power in the former communist countries. Even many predominantly market capitalist economies are making efforts to move in the direction of a purer version of this system. It seems, as Fukuyama argues, to be the victorious universal ideology of the world.

We have never seen a pure version of the system anywhere in history, nor are we likely to. Probably the closest to pure market capitalism ever seen were the U.S. and British economies in the middle to late 19th century. They represented the culmination of a historical line of development that, originating in the murky mists of time, formed a coherent system in the 1200s in northern Italy and Flanders with the invention of modern accounting and mass urbanization, and transformed itself into a dominating structure with the Industrial Revolution in Great Britain in the late 18th century. But even at its apogee in the 19th century, governments intervened in many ways, from trade protectionism to subsidizing the building of transportation infrastructure to maintaining military forces.

Those economies exhibited both the virtues and difficulties of unfettered market capitalism. They experienced enormous technological advances and growth as they underwent the Industrial Revolution. Even those critics of

market capitalism, Karl Marx and Friedrich Engels, recognized the enormous ability of the system to "revolutionize the means of production" in ways unprecedented in world history.

However, both economies experienced large macroeconomic fluctuations with serious downturns in the 1870s and 1890s and increasingly unequal distributions of income associated with increasing concentrations of industrial monopoly power. After 1900 these problems triggered substantial movements towards greater government involvement in both economies, in the United States especially after the 1930s Great Depression.

Today the economies that come the closest to the ideal of pure, laissez-faire, market capitalism may be Hong Kong and Switzerland. Both have successful records in many ways. In recent decades Hong Kong has enjoyed one of the highest growth rates in the world along with very low unemployment. We shall consider the case of Hong Kong in Chapter 15, but note that, much like in Japan, Hong Kong authorities have used indicative planning. Also Hong Kong is not an independent country but a Crown Colony of Great Britain and is scheduled to revert to the control of the People's Republic of China in 1997. Hong Kong may become less laissez-faire after that.

Switzerland has one of the highest real per capita incomes of any country in the world. Like Hong Kong it also has had very low unemployment rates. It clearly is a success story of market capitalism. Switzerland has an especially weak central government, although the central bank is famous for its strict monetarist policy controlling inflation. Most of the power and fiscal authority lies in the hands of the cantons, local units based on the ethnic divisions of the country. These cantons engage in quite a bit of social welfare spending and market regulation that is similar to, though less than that practiced by the social market economies of northwestern Europe.

The relatively harmonious relations among the Swiss cantons have made them a model for other nations with much ethnic diversity, such as Lebanon and Yugoslavia. Switzerland has had a long record of neutrality and independence from international organizations, exemplified by a recent vote to stay outside of the European Union.

Some very poor less developed countries have smaller state sectors relative to GDP than Hong Kong or Switzerland, for example, Malawi.[1] But most of these also have poorly developed markets and little modern industrial capitalism. Probably the developed economy most oriented to market capitalism after Hong Kong and Switzerland is the United States, despite its substantial increase in government intervention since the 1930s. In considering the practice of market capitalism in this chapter we shall draw heavily from the U.S. example.

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[1] An argument known as *Wagner's Law* asserts that as an economy's income rises the relative size of its state sector expands.

The dynamic efficiency or technological dynamism of market capitalism is its greatest appeal to countries seeking to emulate its successes. But this dynamism has come through the macroeconomically destabilizing process of *creative destruction* as described by Joseph Schumpeter.[2] It is with respect to static efficiency that most economists see market capitalism as possessing significant advantages, although Adam Smith strongly argued for both market capitalism's dynamic and static advantages.

The Theoretical Efficiency of Market Capitalism

Why have the countries with the highest real per capita incomes in the world also had market capitalist economies, notably Switzerland and the United States? Probably the strongest reason is the general ability of markets to *efficiently* allocate goods and resources through the law of supply and demand. This general ability is summarized in the following theorem: *A complete, competitive, full-information general equilibrium is efficient.*

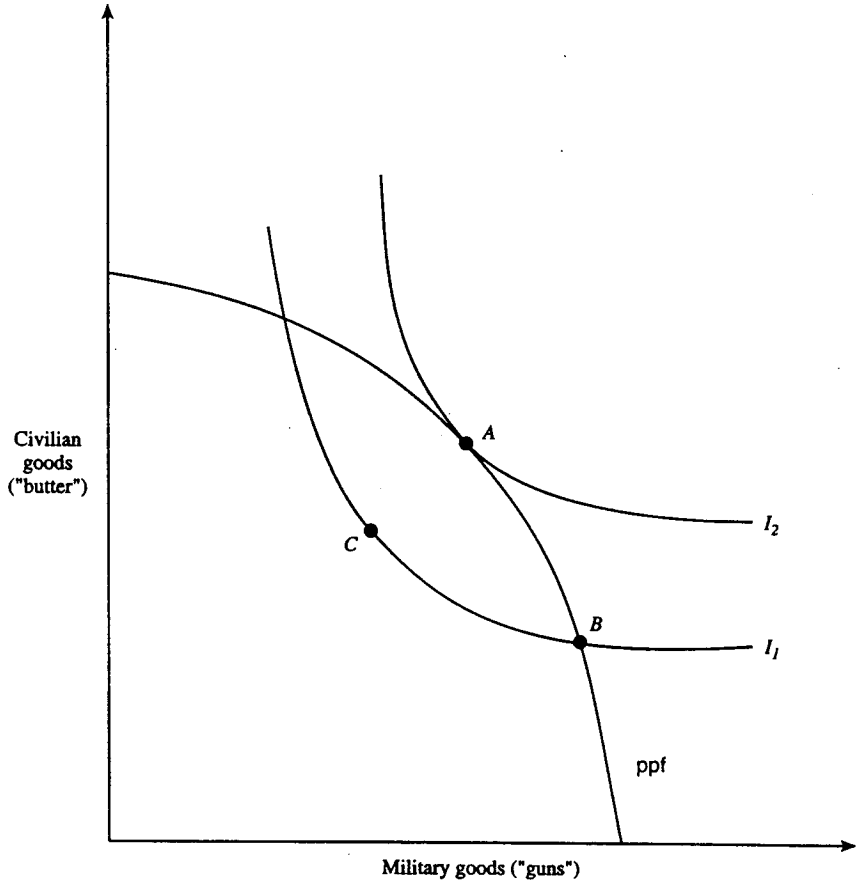
To understand this theorem, its implications, and its limitations, it is necessary to know what the terms in it mean. *Complete* means that for any good or service that affects someone's utility, there is a market. *Competitive* means that there are many buyers and sellers with free entry and exit, that there are well-defined homogeneous goods and services, and that no individual supplier has any control over the price in the market. *Full information* means that all actors in the economy know everything about consumer preferences, production technologies, prices, or anything else they might need to know for deciding how to act. *General equilibrium* means that every single market is in equilibrium in the sense of the quantity supplied equaling the quantity demanded of the good or service in question. If only one market is in equilibrium this is *partial equilibrium. Efficiency* means Pareto optimality, after the Italian economist Vilfredo Pareto. No one in the economy can be made better off without making someone else worse off. If someone can be made better off without making someone else worse off, then the economy is not producing as much as possible. But if Pareto optimality holds, no more can be produced; all that can be done is to reshuffle existing goods and services between people.

Thus the economy is on its production possibilities frontier (ppf), defined as the set of maximum possible output combinations the economy can produce given its resources and technology. But not all points on the ppf are efficient because they may be combinations of goods and services people do not want. The Soviet economy may have been on its ppf, but it was thought to produce too much military and not enough civilian consumer goods.

An efficient economy must be a fully employed economy. Otherwise it would be inside the ppf because the unemployed could presumably produce

[2]Joseph Schumpeter, *The Theory of Economic Development* (Cambridge: Harvard University Press, 1934).

FIGURE 2–1 Production Possibilities Frontier



at least more of one good without reducing the output of another. Thus microeconomic efficiency implies macroeconomic full employment.

Figure 2–1 shows a ppf with point *A* being Pareto optimal at the tangency between the social indifference curve[3] and the ppf, *B* at a lower level of utility on the ppf, and *C* representing a point of unemployed factors located inside the ppf.

[3]To draw such curves implies everyone has identical preferences, a strong simplifying assumption. For a discussion of the difficulty in forming a social welfare function democratically when peoples' preferences differ, see Kenneth J. Arrow, *Social Choice and Individual Values*, 2d ed. (New York: Wiley, 1963).

This concept of efficiency says nothing about income distribution. An economy might be efficient in Pareto's sense that has a completely equal distribution of income or that has one person with everything and everyone else starving to death, just as long no one can be made better off without making someone else worse off. There might be an "equity-efficiency" trade-off. But that argument involves a different concept of efficiency than Pareto optimality, namely maximum economic growth over time.

The tendency to unequal wealth and incomes under market capitalism has been one of the major arguments against it raised by socialist critics. But this is a criticism distinct from the issue of economic efficiency. The existence of a general equilibrium presupposes a prior distribution of wealth with the income distribution arising from the general equilibrium itself.

Returning to the main argument, why is a complete, competitive, full-information, general equilibrium efficient? The underlying intuition of this argument dates to Adam Smith's invocation of the "invisible hand" of the market working across all sectors to allocate goods in a way that maximizes the "wealth of nations," although Smith had no formal concept of a general equilibrium, which was defined first by Léon Walras in 1874. Although Pareto argued for the link between general equilibrium and efficiency in 1909, it was Kenneth J. Arrow and Gerard Debreu in 1954 who presented a formal mathematical proof of both the existence and efficiency of competitive general equilibrium.[4]

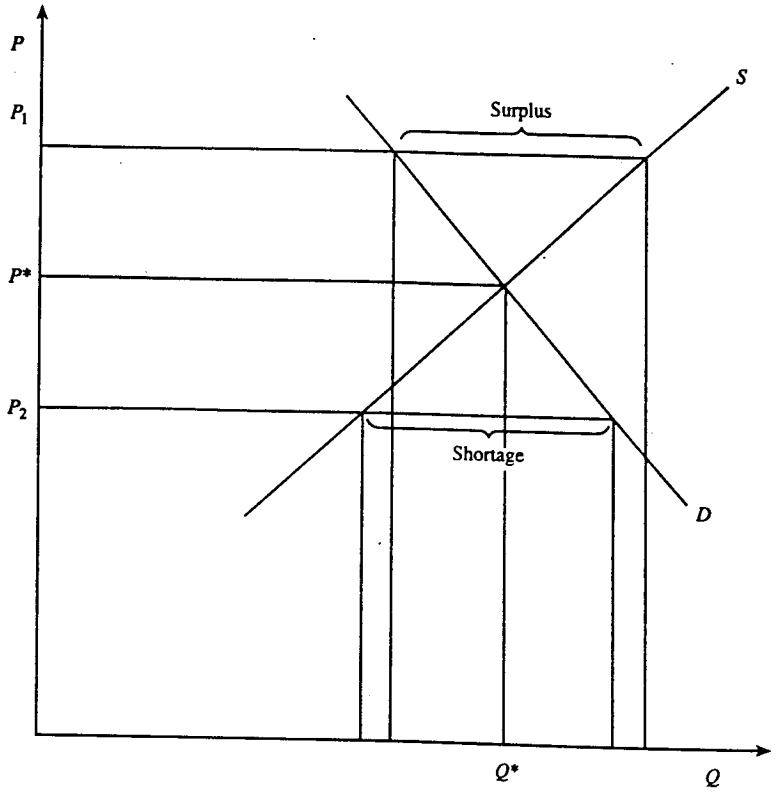
The efficiency of competitive equilibrium is most easily seen by looking at the partial equilibrium case, the outcome in a single market. Figure 2–2 shows a typical competitive market with an upward-sloping supply curve and a downward-sloping demand curve. The solution for three different prices is shown; P_1 above equilibrium, P^* at equilibrium, and P_2 below equilibrium. Q^* is equilibrium quantity.

At P_1 suppliers produce more than they would at equilibrium but demanders buy less than they would at equilibrium, resulting in a surplus equal to the quantity produced that no one wants to buy. The amount that is both produced and sold is less than occurs at the equilibrium. At P_2 demanders buy more than they would at equilibrium but suppliers produce less than they would at equilibrium, resulting in a shortage equal to the quantity buyers want that has not been produced. Again, the amount that is both produced and sold is less than occurs at the equilibrium.

It is at the equilibrium price that the maximum amount will be both produced and sold and thus actually consumed by the public. This argument extends to all markets in the general equilibrium case. Thus to maximize the amount of all goods available for consumption, every market should be in equilibrium.

[4]For a discussion of this history and these arguments, see Kenneth J. Arrow and Frank Hahn, *General Competitive Analysis* (San Francisco: Holden-Day, 1971), Chapter 1.

FIGURE 2–2 Equilibrium of Competitive Supply and Demand



Limits to the Efficiency of Laissez-Faire Market Capitalism

Monopoly Power

No one should underestimate the power and significance of the efficiency theorem. However, no one should be fooled into thinking that absolute laissez-faire market capitalism fulfills the conditions of the theorem and is therefore efficient. In general, laissez-faire market capitalism will not be efficient, which is called the problem of *market failure.*

One condition of efficient equilibrium is that it is competitive. Monopoly power is a source of inefficiency and can arise in a laissez-faire economy. An example is the merger wave that occurred in the United States at the end of the 1890s, culminating in the greatest concentration of monopoly power in U.S. history. This concentration was attacked by President Theodore Roosevelt, the "Trust Buster," after 1901.

FIGURE 2–3 Monopoly and Perfect Competition Compared

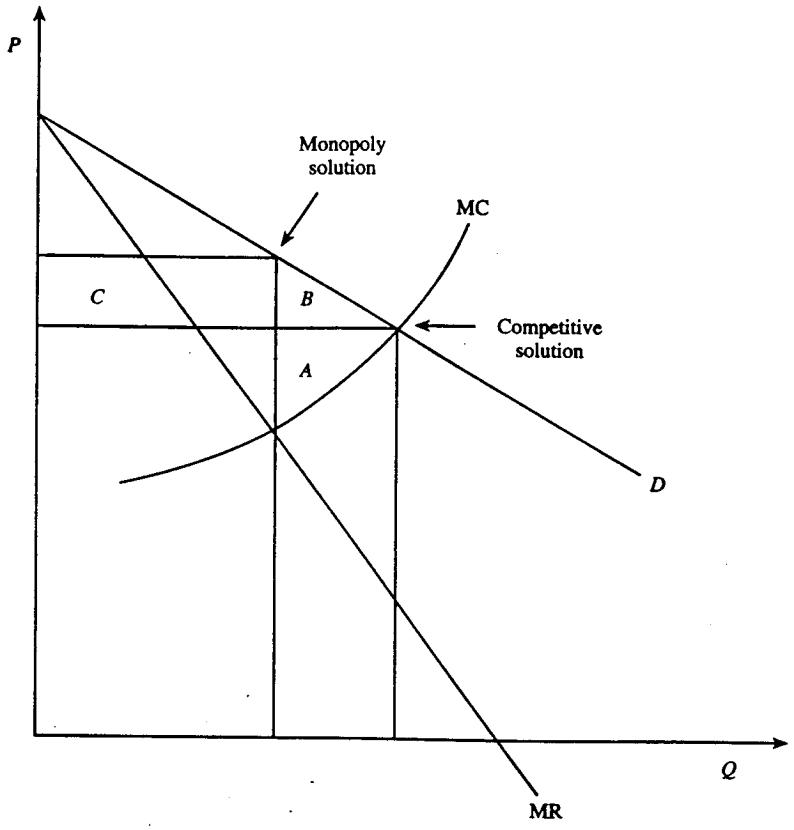


Figure 2–3 compares a pure monopoly outcome with a perfectly competitive solution. The monopolist will maximize profits by setting marginal cost (MC) equal to marginal revenue (MR) whereas if the industry is perfectly competitive the equilibrium will be at P = MC, where MC intersects the demand curve. The monopolist will produce less and charge a higher price than would the competitive industry. Triangle A shows lost income for the producer and triangle B shows lost consumer's surplus (net utility) due to the reduced production. Despite the loss of triangle A, the producer has a net gain because he obtains the larger rectangle C from the consumer because of the higher price.[5]

[5]Probably the basis for political support for antitrust policy in the United States is this "rectangle of redistribution" rather than the missing "triangles of inefficiency." Consumers get angry when "ripped off" by a monopolist whose increased income may be quite visible. The missing triangles are invisible because they do not exist, and according to some estimates are only on the order of 1 percent of GDP anyway.

Despite this apparently cut-and-dried case, caveats are in order. The first is that natural monopolies, industries with economies of scale (declining long-run average costs) even at a level of output equal to total market demand, exist. One firm can produce the total market demand at a lower cost than more than one firm can. Such a case is the electric utility industry. Societies like to take advantage of the efficiencies of large-scale production of electricity.

The existence of natural monopoly presents an inevitable trilemma. Laissez-faire can be followed, in which case consumers will get ripped off. Or the government can regulate the monopoly as state governments do in the United States with electric utilities. Regulation often leads to distortions such as overinvestment in capital stock when firms are guaranteed a particular rate of return on invested capital. Or the natural monopoly can be run by some level of government, which is socialism with all its tendencies to bureaucratic inefficiency, the solution followed in most of Western Europe for electric utilities.

Another caveat involves technological dynamism. It is argued that more competitive industries will be more technologically dynamic because of the pressure of competition. But if research and development (R and D) involve economies of scale, then a large monopolist with large monopoly profits may generate more R and D if it can be sufficiently motivated, an argument made by Joseph Schumpeter in his *Capitalism, Socialism and Democracy.* A possible example of such a "technologically progressive monopoly" in the United States may well have been AT&T with its Bell Laboratories prior to its breakup in 1982, although it can be argued that AT&T was so innovative because it perceived the threat of potential competition that eventually arrived.

Intermediate forms, notably *monopolistic competition* and *oligopoly,* lie between pure monopoly (one firm) and perfect competition (many firms, none with any control over price). Monopolistic competition involves many firms, each having some price-setting power from product differentiation. Some customers will stick with the firm when it raises price because of perceived uniqueness of its product. In the long run such firms produce at a lower level of output than they would if their average costs were minimized, the "excess capacity theorem." However, there is little that any government can do about this and none have tried.

Oligopoly, with a small number of firms in the industry, is a more complicated matter. There are many different models of oligopoly behavior because the optimal behavior of an oligopolist depends on how its fellow oligopolists react to any action it takes. Different reactions imply different outcomes.

Generally, oligopolistic industries range from very monopolistic to very competitive. At the monopolistic extreme is *perfect collusion,* the joint profit-maximizing cartel. Cartels tend to be unstable because a cartel member can make extraordinary profits by "cheating" through price cutting. The oil cartel, OPEC (Organization of Petroleum Exporting Countries), raised oil prices in 1973 and 1979, but in 1986 lost control of the world price as Saudi Arabia

increased production to punish Iran and Iraq for cheating on their production quotas. Probably the longest surviving cartel in the world is the diamond cartel, based in South Africa. In the United States most cartels are illegal.

At the other extreme some oligopolistic industries behave like perfectly competitive ones, charging prices equal to marginal costs. These are known as *contestable markets* and are most likely where there are few barriers to entry and exit and the threat of potential, if not actual, competition is ever present. Firms behave competitively to forestall potential entrants. The U.S. airline industry might have been an example. The existence of contestable markets suggests taking a laissez-faire attitude with respect to oligopolies because they may be efficient and competitive, constantly innovating and investing to keep one step ahead of potential competitors.

Among all market economies, the United States has had the most vigorous antitrust policy over time. The beginning of its policy, and still its most used instrument, was the Sherman Act of 1890, which forbids "combinations in restraint of trade" and "efforts to monopolize interstate trade." The Sherman Act was supplemented by the Clayton Act of 1914, which forbids monopolistic stock mergers, interlocking directorates, tying contracts, and price discrimination; the Federal Trade Commission (FTC) Act of 1914, which forbids false advertising; and several later laws. The FTC and the Antitrust Division of the Department of Justice have been the main antitrust enforcement bodies of the U.S. government.

Since 1890 U.S. enforcement of antitrust policies has oscillated back and forth. From 1901 to 1920 enforcement was quite vigorous, from 1920 to 1945 enforcement was more relaxed, and from 1945 to 1982 enforcement was more vigorous. Since 1982 enforcement has been more relaxed, largely because increased competition from foreign imports, especially from Japan, has reduced the need for enforcement.

Controversy exists regarding the actual time path of industrial concentration in the United States. Market share and ownership of assets by the very largest firms have increased some. But taking into account foreign competition, competitiveness has probably increased.

Generally the United States has a more competitive and less concentrated economy than others. This is because of its sheer size—it can support more firms in most industries than can many smaller economies. But this also reflects the stronger tradition of U.S. antitrust enforcement. A limited cross-country comparison is shown in Table 2–1.

The major anomaly in this table is the apparently lower degree of concentration in Japan than in the United States. In Japan, many firms that are officially independent have very close relationships with other firms through the "family of companies" groupings known as *keiretsu*.[6] South Korea has

[6]See Chapter 6.

TABLE 2.1 Industrial Concentration Compared

Country Top Ten Firms	*Average Size Top Ten Firms*	*Percent Employment Concentration Ratio*	*Average Three-Firm*
United States	310,554	13.1	41
Japan	107,106	7.3	n.a.
W. Germany	177,173	20.1	56
United Kingdom	141,156	23.1	60
France	116,049	23.2	66
S. Korea	54,416	14.9	n.a.
Canada	36,990	15.3	71
Switzerland	60,039	49.4	n.a.
Sweden	48,538	49.4	83

Source: The first column shows the average number of employees in 1985 in the 10 largest firms and the second column is the percent of industrial employment in those firms in 1985, both figures from Frederic M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990), p. 63. The third column shows simple average of market share held by the three largest firms in 12 industries in 1970 and is from Frederic M. Scherer, M. Alan Beckenstein, Erich Kaufer, and R. D. Murphy, *The Economics of Multi-Plant Operations: An International Comparisons Study* (Cambridge: Harvard University Press, 1975), pp. 218–19 and 426–28.

similar groupings known as *chaebol.*[7] Both Japan and South Korea have higher degrees of concentration relative to the United States than Table 2–1 indicates.

A final remark on monopoly involves its role in the transformation of the former command socialist economies into market capitalist ones. Many industries in the former command socialist economies are state-owned monopolies. Eliminating central planning and controls on prices has allowed these firms to behave monopolistically with resulting aggravation of inflationary tendencies, unresponsive output, and rising resentment by consumers. Furthermore many of these firms are so big that shutting them down threatens social upheavals from high unemployment. Thus the problem of monopoly power is serious for economies making market transitions.

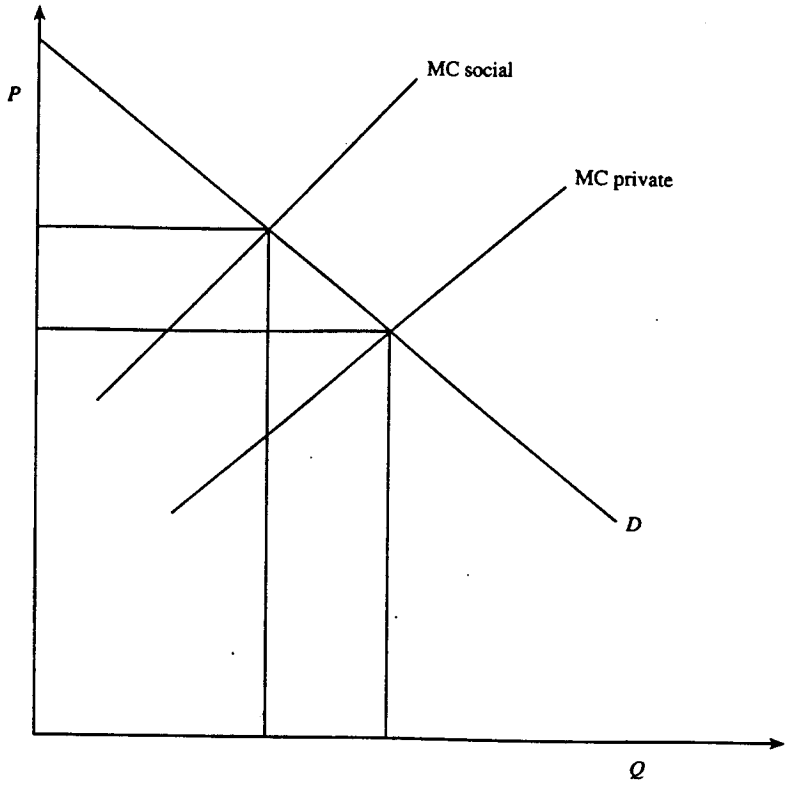
Externalities

Another source of inefficiency in a laissez-faire equilibrium is externalities. These are either costs or benefits that are borne by or accrue to someone other than the person or entity generating them. External costs are called *negative externalities,* the most controversial being environmental pollution. External benefits are called *positive externalities,* one example being technological invention when there is no patent protection for inventors.

A firm generates pollution damaging another industry but does not minimize that damage if it does not have to pay for it. Private marginal cost to the firm does not equal social marginal cost and too much pollution is produced, resulting in inefficiency. If an inventor has no patent protection, the

[7]See Chapter 18.

FIGURE 2–4 Negative Externality



other firms can steal his invention, and he may make no money even if his invention generates great social benefits. Private marginal benefit to the inventor does not equal marginal social benefit of the invention and too little inventing will occur, resulting in inefficiency. The case of a negative externality is depicted in Figure 2–4.

For the efficiency theorem the problem raised by the existence of externalities, either positive or negative, is an *incompleteness of markets.* For unaccounted-for pollution there is no market for environmental quality even though environmental quality is something people desire and that provides utility for them. It has long been argued that the solution to pollution, or externalities in general, is to "internalize" them, to make sure that those generating the externalities either bear the costs or receive the benefits they generate.

Four broad approaches to resolving the problem of externalities have been proposed within market economies. The earliest one was that of A. C. Pigou,[8]

[8]A. C. Pigou, *The Economics of Welfare* (London: Macmillan, 1922).

who suggested taxation of negative externalities and subsidies of positive externalities. For pollution, the tax would equal the difference between the marginal private cost and the marginal social cost, as shown in Figure 2–4. The commodity whose production generates the pollution would be priced higher, and its production would be reduced. The people who consume the polluting commodity ultimately would bear the cost.

This taxation strategy seldom has been tried in the United States. Countries using it include France and West Germany, where the thrust of policies is not to raise the cost so high as to discourage polluters from polluting, but to raise money for subsidy programs that pay polluters to clean up.

A second policy, widely used in the United States, is command and control quantitative or technological restrictions. In terms of Figure 2–4 an efficient strategy moves the equilibrium from the private one to the social one. The optimal size of such a move will vary from industry to industry and from region to region. The social costs of pollution are higher in New Jersey than in North Dakota because of the greater number of people affected by pollution in New Jersey. Nevertheless the tendency until recently has been to apply the same emissions or technology standards for a given industry everywhere. Such an approach is inefficient, although it might be justified on grounds of minimizing administrative costs.

A third approach takes a more laissez-faire attitude and emphasizes the clear definition and enforcement of property rights. This approach derives from the Coase Theorem, which states that if property rights are well defined and negotiation costs are negligible, then externalities will be internalized automatically by a market capitalist economy.[9] Coase presents the example of a railroad whose trains generate sparks that start fires on property adjacent to the railroad's tracks. By mutual negotiation a solution is worked out, such as the railroad compensating the property owners or buying their property. Coase argues that it is irrelevant whether the polluter pays the pollutee for damages or the pollutee pays the polluter not to pollute, although all current law and international agreements contain "polluter must pay" clauses.

When property rights are poorly defined and a natural resource is an open access, common property resource, such as fisheries in international waters, there is a tendency for the resource to be overexploited. No one accounts for the effects of his behavior on others using the resource, so a gap between private and social costs emerges. For fisheries such overexploitation leads to the collapse of fish populations as has happened to many species. The essential issue is that of open access rather than common property. Thus the USSR managed the Caspian caviar fisheries well by controlling access, but after its dissolution there was drastic overfishing and a collapse of caviar production as newly independent republics bordering on the Caspian Sea all wanted access.

[9]Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3, (1961), pp. 1–44.

Box 2–1

Trading in Offsets in the U.S.

The U.S. Environmental Protection Agency has set upper limits on the emissions of particular pollutants within certain regions. Thus if a region is at its limit and a new business wishes to open that would put the region over the limit, it must negotiate a deal with an existing business to reduce emissions by the requisite amount. Such a deal is known as an "offset" and has been increasingly used to maintain air quality without hampering economic growth. Examples include the following:

1. A cement company in Texas that entered into an agreement with another local company in which it paid the other company for dust-collecting equipment that the other company agreed to install and maintain, the latter a negligible cost.
2. A city-owned refuse-burning power plant in Columbus, Ohio, paid for the installation of pollution controls at two privately owned asphalt plants and for increasing the height of the smokestack at a third plant.
3. A company in Contra Costa County, California, built an oil terminal after paying $250,000 for a permit for an offset created when a local chemical company shut down.
4. The state of Pennsylvania created an offset by altering its road-paving practices to reduce hydrocarbon emissions and used this offset to help attract Volkswagen Corporation to locate a plant in the state.

Source: Tom Tietenberg, *Environmental and Natural Resource Economics*, 3rd ed. (New York: Harper Collins, 1992).

The Coase Theorem implies serious limits: Property rights may be impossible to define and negotiation costs may be very high. These conditions are likely to coincide when the externality involves an inherently collective good "owned" by large numbers of people such as global air quality and global climate in the discussions of global warming and ozone depletion. Everyone in the world is involved both as a source of pollution and as an "owner" of the global climate affected by everyone else's actions. As the difficulties surrounding the global negotiations at the 1992 Rio Conference on the Environment show, these disputes are far from costlessly resolved.

Nevertheless awareness of the Coase Theorem has stimulated the search for the use of market mechanisms where possible to resolve pollution problems. An innovation that has spread rapidly in the United States has been using tradable emissions permits, which involve government setting some overall quantitative limit for the emission of a particular pollutant for a particular area.

The government then issues permits for emissions adding up to that total that firms may buy and sell from each other, thereby creating an artificial market for pollution cleanup. The U.S. Clean Air Act of 1990 relies on this approach.

Marketable emissions permits directly attack the problem of "incomplete markets" underlying the inefficiency of unresolved externalities. As long as there are enough parties to make such a market reasonably competitive, it will achieve the lowest cost solution to cleaning up the given amount. Those firms that can clean up cheaply do so and sell their "permits to pollute" to those who cannot. One form of this program involves offsets as described in Box 2–1.

Active efforts to deal with environmental problems originated in the highest income countries first and generally in the market capitalist countries before the command socialist countries despite the theoretical ability of the latter to plan for avoiding pollution. This pattern may be due more to the greater democracy of the advanced market capitalist economies than due to the inherent nature of their economic systems.

The level of development of an economy and its amounts and kinds of pollution seem to be strongly related. Poorer countries seem to have worse water pollution and more particulate matter in the air. Richer countries tend to emit more greenhouse gases, especially carbon dioxide from fossil fuel burning. Middle-income countries tend to emit the most sulfur dioxides responsible for acid rain, largely a result of burning high-sulfur coal.

Data on different air pollutants in different countries are shown in Table 2–2. Carbon dioxide (CO_2) per capita shows strong correlation with income levels—it reaches a peak in some oil-rich Persian Gulf states, although the United States is not too far behind. Nitrogen oxides (NOX), which come largely from automobiles, also increase in market capitalist economies with more cars, and the United States is at the top of the list of per capita output. Sulfur dioxide (SO_2) comes from burning dirty coal and oil, and per capita emissions are the highest in heavily industrialized command socialist countries, although the United States has the highest levels among the market capitalist countries.

Collective Consumption Goods

Another source of inefficiency for laissez-faire equilibrium is collective consumption goods, also known as *public goods.* The latter name is circular because such goods frequently are provided by the public sector even in strongly market capitalist economies. Why? Calling them "public goods" does not answer the question, but identifying them as "collective consumption goods" emphasizes why the public sector provides them.

The source of the efficiency problem with such goods is incomplete markets. Because of the nature of collective consumption goods it is difficult for private markets to organize themselves to provide them in optimal quantities. Thus it falls to the public sector to do so, although such provision is afflicted with the usual difficulties and inefficiencies associated with the public sector.

TABLE 2–2 Pollution Emissions in Various Countries

Country	*CO_2 Per Capita*	*NOX Per Capita*	*SO_2 Per Capita*
Niger	0.15	n.a.	n.a.
Egypt	1.54	n.a.	n.a.
Mexico	3.70	n.a.	n.a.
China	2.16	n.a.	n.a.
India	0.77	n.a.	n.a.
Laos	0.07	n.a.	n.a.
S. Korea	5.20	n.a.	n.a.
Japan	8.46	n.a.	n.a.
Iran	3.11	n.a.	n.a.
Qatar	37.59	n.a.	n.a.
Albania	3.06	2.8	15.6
Bulgaria	11.87	16.7	114.6
Czechoslovakia	14.47	60.7	178.9
Hungary	6.05	24.5	115.2
Poland	11.54	39.1	103.3
Romania	9.16	16.8	8.6
Yugoslavia	5.61	8.0	69.6
USSR	13.26	14.6	32.4
E. Germany	10.48	42.6	313.3
W. Germany	10.48*	48.4	24.2
France	6.38	30.1	27.1
Sweden	7.00	35.4	25.9
United Kingdom	9.89	43.9	62.1
United States	19.68	79.6	83.2

*The CO_2 figures are averaged across all of Germany.

Source: All figures are for 1989 and are from World Resources Institute, *World Resources, 1992–93* (Oxford: Oxford University Press, 1992), pp. 64–65 for NOX and SO_2 (which are in kilograms) and pp. 346–47 for CO_2 (which is in metric tons).

National defense is an archetypal such good and the cost overruns of the U.S. defense establishment are legion.

The characteristics of a pure public good are *nonexcludability of consumption* and *nondepletability of consumption,* of which the former is more crucial. These two characteristics together imply that the very essence of the good is collective. Everyone consumes it simultaneously and no individual's consumption of it takes away from any other individual's consumption of it. National defense is a classic example and is almost universally provided publicly, even in strongly market capitalist economies. If one individual is defended from foreign invasion then all individuals are so defended, irrespective of whether or not they paid for it.

The essential problem for market provision of true collective consumption goods is the *free rider problem.* The collective nature of the good breaks the

link between paying for it and consuming it. If it exists, everyone consumes it whether or not they paid for it. Thus if the private sector were to attempt to provide the good it would have a great deal of trouble selling the good. Many individuals who actually want the good to be provided will not pay for its provision because they can free ride and consume it for free. Even though people want the good they will not pay enough for it to be provided to the Pareto optimal level. The government must use taxation to bring about adequate provision of the good.

One criticism of this view comes from the philosophical perspective known as *methodological individualism,* associated with the pro–laissez-faire Austrian School. An even more extreme version of this view is associated with the objectivist philosophy of the novelist Ayn Rand, which argues that there is no such thing as a human collectivity; ultimate reality is individual people. All apparent collectivities are illusions created to subject individuals to arbitrary tyrannies. However the Austrian School, at least Friedrich Hayek, recognizes the existence of some minimal public goods, notably the constitutional maintenance of basic law and order for the protection of property rights and the functioning of free markets.

Between the extremes of pure private goods such as food and pure public goods such as basic law and order there is a wide spectrum of intermediate goods that have both private and collective aspects. One example is education, which is provided by a mix of public and private sources in the United States, with public sources more prominent at lower grade levels and private sources gaining in significance at higher educational levels. Widespread literacy and elementary education of the populace has a significant collective component because it teaches people how to behave as citizens within the society at the most basic level. At higher levels of education individuals are more able to appropriate for themselves the benefits of their education, although there are still arguably broader spillovers.

This broad spectrum allows much room for variation across societies, even among largely market capitalist economies, regarding the public versus private provision of such intermediate goods. The recent movement in many countries to privatize previously public activities highlights this debate with no clear boundaries or criteria regarding what should be done by whom.

Compared to most other market economies the United States provides more of these intermediate activities privately. Nevertheless the U.S. economy has a substantial public sector, the most rapidly growing part of which has been at the state and local levels. At the federal level there has always been substantial government ownership of land, especially in the West. Overall public ownership of land and structures is on the order of 15 percent of the respective totals. These figures represent moderate declines from 1939, when a period of increasing government ownership ended. Areas with significant public participation in the United States include law and order, national defense, the National Forest Service and National Park Service, major dams, the

space program, the Tennessee Valley Authority,[10] and numerous local public services such as education, fire protection, local transportation, airports, harbors, highways, garbage collection, water, sewage disposal, libraries, and even some locally owned utilities. All of these are subject to debate about whether or not they should be privatized.[11]

Finally the *public choice school*[12] of thought observes that decisions regarding private versus public ownership are made by legislative bodies at whatever level of government. These bodies are subject to all the complexities of majority rule, logrolling, special interest groups, and sheer inertia, suggesting that they are ill-suited to efficient decision making regarding the proper balance between the private and public sectors. Even though there is a case for public provision of collective consumption goods, the public choice school sees the public sector as so inefficient and corrupt that generally privatization will be the preferred solution.

Imperfect Information

Of all the assumptions needed for efficiency of an equilibrium outcome, that of perfect information is the most unrealistic. There is no perfect information anywhere about anything.

This problem of imperfect information has spawned a new field, the "economics of information." A major breakthrough came with George Akerlof's analysis of the used-car market in which there is asymmetry of information between the owner of the used car who knows its flaws and the potential customer who does not.[13] But the potential customer understands this and therefore is suspicious of all used cars, suspecting them to be lemons their owners wish to dispose of. The victims of the resulting inefficiency will be anyone who seeks to sell a used car that is *not* a lemon at a decent price. Potential sellers who recognize the problem reinforce it: Those with good cars who do not *have* to sell won't.

Such asymmetries are rife in market economies. In contractual relationships they lead to *principal-agent* problems where someone is hired who does not do what is best for the employer because of his ability to mislead the ignorant employer. Such asymmetries can lead to suboptimizing behavior because of *moral hazard,* especially in the insurance industry. Those most needing insurance will seek it out and will conceal their need from the insurers,

[10]As the only federally owned utility in the country, established during the New Deal of the 1930s, the TVA has had a controversial and mixed record.

[11]In some cases partial privatization is what has happened, as with the Federal National Mortgage Association ("Fannie Mae").

[12]Also known as the "Virginia School," its founders were James Buchanan and Gordon Tullock.

[13]George Akerlof, "The Market for Lemons," *Quarterly Journal of Economics* 84 (1970), pp. 488–500.

thereby raising rates for those who need insurance less. Those who are insured then may behave in ways they would not if they were uninsured. Such moral hazard has been adduced as a cause of the U.S. Savings and Loan crisis. Financial institutions engaged in reckless lending practices because depositors were not scrutinizing the institutions' behavior because their deposits were insured by the government.

There is no easy way out of the dilemmas posed by imperfect information and asymmetries of information. However a possible melioration available to government is simply increasing the amount of relevant information generally available. This constitutes an economic efficiency justification for government data-gathering agencies such as the Bureau of Labor Statistics and the Census Bureau. A trial balloon to privatize information gathering and disseminating by the U.S. National Weather Service that was floated during the Reagan Administration created a storm.

Another perspective is that the very essence of markets is information transmission. Hayek argues that a central planner can never possess adequate information for carrying out optimal or even remotely intelligent planning. Free capitalist markets may suffer from imperfect information, but they beat command socialist planning in this area, according to this view.

In the Hayekian vision it is prices themselves that serve as the transmitters of information regarding relative scarcities. Decentralized and profit-motivated market capitalists respond to price signals in ways that move the economy along optimally even though the individual actors only possess limited knowledge.[14] This emphasis on prices as information signals, even in a world of asymmetries and imperfection, has been much emphasized in the more recent economics of information. But ultimately the problem of imperfect information remains unresolved for all economic systems.

Some Other Problems Regarding Laissez-Faire

Merit Goods and Orphan Goods. The preceding discussion cites the main reasons why laissez-faire equilibria may not be efficient. Several other arguments against laissez-faire have been put forward, sometimes carrying the inefficiency label. But these arguments have little to do with efficiency or they can be subsumed as special cases of one of the above categories of laissez-faire inefficiency.

One of these special cases is *merit goods.* These are goods that society approves of and seeks to encourage the consumption of, especially in comparison with some other presumably less than merit goods. This is not an efficiency argument but one of value judgment and officiousness by those in

[14]Prices may not always accurately transmit information as with speculative bubbles, in which prices rise because agents are busy expecting them to rise.

authority with regard to those not in authority. For example, societies ban the consumption of "sin" goods such as certain kinds of drugs, prostitution, gambling, or pornography, among other not-so-good goods. Conceivably there are potential externality issues involved, as for example if drug addicts commit crimes to support their habits or prostitutes spread venereal diseases.

A variation of merit goods involves income redistribution programs. Standard economic arguments suggest that efficient redistribution schemes should be as cash. But in the United States much redistribution takes in-kind forms such as food stamps, public housing, and Medicaid. The reason is that these are considered merit goods that the poor *should* be consuming. Society doesn't give them cash because who knows what they might spend it on!

A related but different argument involves *orphan goods.* These are considered to be especially meritorious, but for lack of a sufficient market under laissez-faire they do not get produced. The classic example is expensive-to-produce medicines for very rare but deadly illnesses. Under laissez-faire the markets may be too small to support production of these medicines, but people feel on moral grounds that they should be provided, with some level of government being the obvious provider of the necessary subsidies. This is currently being done in the United States by the federal government.

Providing such orphan goods may well be a legitimate function of government, but it does not involve correcting an inefficiency. The economy may already be Pareto optimal, and the taxes for these subsidies reduce someone else's utility. The real problem is one of income distribution rather than inefficiency. If those with the rare illnesses in question had sufficiently high incomes they could pay enough to support production of the necessary medicines. Subsidization of the production of these orphan drugs is indirectly a way of redistributing income to those with the rare illnesses.

Capital Market Myopia. Another possible source of inefficiency is that laissez-faire financial markets generate real interest rates that may be inefficiently high. If so then those markets are overvaluing the present and undervaluing the future, myopia or shortsightedness. Thus, perhaps, government should intervene either to push down interest rates or to use lower-than-market interest rates for calculating benefits and costs of public investment projects.

There is reason to take this argument seriously. However it reflects applications of two of our previously given reasons for possible laissez-faire inefficiency. Most important is externality, particularly an "intertemporal externality" with respect to future generations who have not yet been born. To the extent that we are selfish those generations have no voice in today's capital markets and decisions may be made that will adversely affect them because of our high interest rate–induced shortsightedness. The other element is imperfect information. The distant future is fundamentally unknown; we do not know future technologies and resource availabilities, much less the preferences of unborn generations.

It may be that this imperfect information provides a rationale for government intervention, presumably through macroeconomic policy to push down real interest rates in order to value the interests of the future somewhat more. But there is no way to know the right amount.

Regarding the question of applying a different rate to public investment projects than that in the private sector, another problem is that such a policy would suck funds out of private capital investment and into public capital investment, in other words, "crowding out." With no reason to believe that public investment is more productive than private capital investment, such a policy risks introducing inefficiency.

The Role of Labor Unions. Another issue arising in market capitalist economies is the organization of labor into unions. If labor markets are perfectly competitive and lacking in discrimination on grounds of characteristics irrelevant to productivity, it can be argued that unions do not contribute to economic efficiency. They are vehicles for redistributing income to their members; dealing with safety, job security, benefits, and social functions; and lobbying politically for broader social outcomes. If unions do not offset monopsonistic power of big firms doing the hiring, their potential for exercising monopolistic power in the supply of labor may result in inefficiency.[15]

Although craft unions resemble the medieval guilds of Europe, modern labor unions arose from the revolutionary socialist movements in the 19th century, even though independent labor unions were snuffed out by command socialist regimes once in power. The Grand Consolidated Trade Union of Britain in the 1830s and the Knights of Labor in the United States in the 1870s were such unions, devoted at least as much to the idea of a general working class revolution as to negotiating bread and butter issues. Given these historical roots, labor unions have tended to be weakest in the most relentlessly market capitalist countries such as the United States.

As the harshness of 19th century capitalism moderated in the 20th century, labor unions both became more legally accepted and moderated their approaches to negotiation and political activism. In the United States the American Federation of Labor (AFL) was founded in 1881 by Samuel Gompers, and it eschewed radicalism for *business unionism.* This group consists of unions of workers in craft unions, organized like guilds along lines of skill categories (carpenters, plumbers, etc.). Although in Europe acceptance of unions came earlier, the environment in the United States remained fundamentally hostile until the New Deal of Franklin D. Roosevelt passed the Wagner Act of 1935, which established the modern U.S. system of collective bargaining.

The Wagner Act triggered a period of intense organizing and a conflict between the AFL and the newly formed Congress of Industrial Organizations (CIO). The CIO included industrial unions such as the United Auto Workers

[15]The original applications of the Sherman Antitrust Act in the United States in the 1890s were against labor unions, although they were very weak at the time. The Clayton Act of 1914 exempted unions from antitrust law.

and the United Steel Workers that were more radical and had less skilled workers. In 1947 a reaction set in with the Taft-Hartley Act, which put restrictions on union activities. By 1955 the percentage of U.S. workers in unions had peaked and the two federations united as the AFL-CIO. Their base in heavy industries means that their membership and influence have declined in the United States as its economy has evolved towards a postindustrial service pattern.

In contrast, labor unions in Western Europe have a larger proportion of the labor force as members, are more centrally organized, are more accepted by the political establishment, and are more influential in pushing towards greater government intervention in their economies. They serve as the main political-economic base for Western European "social democracy."

Countries vary considerably. In some countries labor-management relations have been cooperative, as in Sweden and Germany, whereas in others they have been contentious, as in France and Great Britain. In Japan, union membership is higher than in the United States, but labor-management relations have been more cooperative. When labor-management cooperation involves economywide negotiating under government encouragement for macroeconomic stabilization, this is known as *corporatism.*[16]

Table 2–3 shows percentages of labor forces belonging to unions for 1955 and 1975 for 13 countries. The U.S. percentage has continued to decline and is now less than 15 percent. The Japanese percentage declined to 28 percent. There is no relation between the degree of unionization and the degree of radicalism of unions. The two least unionized countries in Table 2–3 are the United States and France. In political terms the former has the most moderate unions on the list whereas in the latter many unions have deep links to the still-orthodox Communist Party of France.

Table 2–4 shows days lost to strikes per thousand nonagricultural wage earners and salaried employees for 1955, 1965, 1975, and 1985 for 15 countries. Generally disputes have declined markedly except in the United Kingdom, Sweden, New Zealand, and especially Denmark. The most disputatious countries were Italy and Canada, and the least, Switzerland.

The impact of unionization on an economy depends on many factors. In the United States unionized workers are paid more than nonunionized workers, which may have contributed to the weakening of unions as high wages led to unemployment in the auto and steel industries. If unions cooperate with management and support flexibility in labor policies high unionization may coexist with low unemployment, as in Sweden until recently. Unions may lead to productivity improvements through giving workers a voice. But if unions insist on restrictive laws, such as ones limiting the ability of firms to fire workers (which discourages firms from hiring workers in the first place), then high unionization may lead to high chronic unemployment, as in Belgium.

[16]Originally corporatism was an authoritarian system promoted by fascists, but now is more of a voluntary system found largely in social democracies.

TABLE 2–3 Percentages of Labor Force Belonging to Unions

Country	1955	1975
United States	24.7	21.7
Japan	n.a.	34.0
Austria	63.0	59.0
Belgium	53.0	66.0
Denmark	59.0	67.0
Finland	31.0	75.0
France	25.0	25.0
West Germany	34.0	33.0
Italy	n.a.	47.0
Netherlands	38.0	40.0
Norway	54.0	61.0
Sweden	68.0	82.0
United Kingdom	44.0	51.0

Source: Data for the United States are from *Economic Report of the President* (Washington: USGPO, 1990). Japanese figures are from Richard B. Freeman and M. E. Rebick, "Crumbling Pillar? Declining Union Density in Japan," *Journal of Japanese and International Economies* 3, 1989, pp. 578–601. European figures are from Jan-Erik Lane and Svante Ersson, *Comparative Political Economy* (London: Pinter, 1990), p. 164.

TABLE 2–4 Days Lost to Labor Disputes per Thousand Workers

Country	1955	1965	1975	1985
United States	429	222	303	74
Australia	361	214	717	230
Belgium	408	28	197	35
Canada	466	459	1,324	319
Denmark	8	153	54	1,087
France	277	71	48	2
West Germany	52	2	3	2
Italy	439	567	1,646	234
Japan	203	201	222	6
Netherlands	46	43	<1	9
New Zealand	81	29	207	703
Norway	116	5	8	39
Sweden	65	1	12	129
Switzerland	1	<1	<1	<1
United Kingdom	180	131	269	303

Source: These figures were provided to us by Robert Horn based on unpublished data gathered by the U.S. Bureau of Labor Statistics, Office of Productivity and Technology, 1988.

TABLE 2–5 Percent of Labor Force Unemployed

Country	*1921*	*1931*	*1951*	*1961*	*1971*	*1979*	*1993*
Australia	5.9	17.9	1.3	2.3	1.8	6.1	10.7
Austria	n.a.	9.7	3.5	1.8	1.2	1.7	5.7
Belgium	6.1	6.8	4.4	2.5	1.7	7.1	13.5
Canada	5.8	11.6	2.4	7.0	6.1	7.4	11.6
Denmark	3.0	9.0	4.6	1.9	1.1	5.2	12.3
Finland	1.8	4.6	0.3	1.2	2.2	6.0	n.a.
France	2.7	2.2	2.1	1.5	2.6	5.9	11.7
Germany	1.2	13.9	7.3	0.7	0.7	3.3	7.5
Italy	n.a.	4.3	7.3	3.4	4.9	7.1	11.3
Japan	n.a.	n.a.	1.7	1.4	1.2	2.1	2.5
Netherlands	1.7	4.3	3.2	0.9	2.3	6.6	6.2
Norway	n.a.	10.2	1.5	1.8	1.5	2.0	n.a.
Sweden	1.3	4.8	1.6	1.5	2.5	2.1	9.0
Switzerland	n.a.	1.2	0.0	0.0	0.0	0.3	4.6
United Kingdom	11.0	14.8	2.2	2.0	3.8	5.1	10.4
United States	11.4	15.2	3.2	6.5	5.9	5.8	6.8

All data are from Angus Maddison, *Phases of Capitalist Development* (Oxford: Oxford University Press, 1982), pp. 206–208, except for 1993, which are from *The Economist* (August 20–26, 1994), p. 80.

Macroeconomic Instability of Market Capitalism

The General Picture

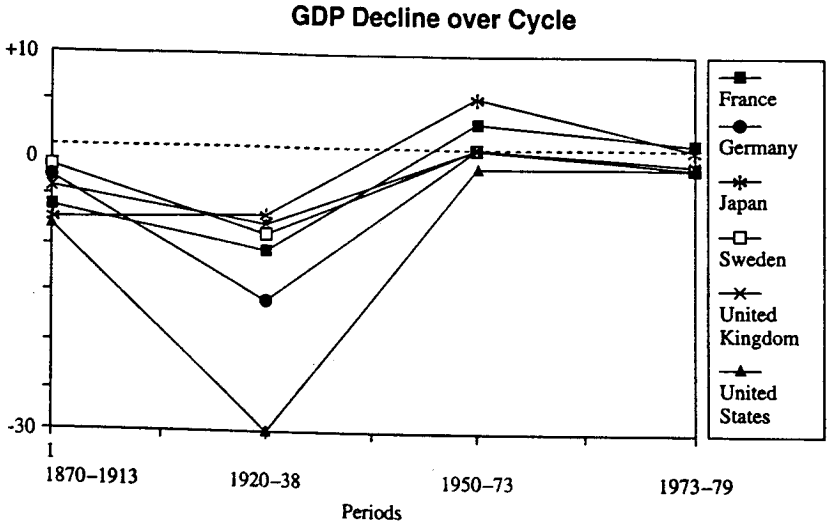
Although involuntary unemployment of labor due to macroeconomic fluctuations implies that inefficiency exists, the significance of macroeconomic fluctuations goes beyond this to constitute a central and distinct issue for market capitalism as a system. It is no accident that the high-water mark of popularity of the U.S. Communist Party was in the Great Depression. Mass unemployment and unequal distributions of income and wealth, rather than inefficiency, have provided the most pungent propaganda for socialist critics of market capitalism.

That the major market capitalist economies have been less than perfectly stable over time is shown in Table 2–5 and Figure 2–5. The former shows unemployment rates[17] for a variety of countries for a variety of years. Unemployment rates have generally increased since the early 1970s associated with the general stagnation of world economic growth.

Figure 2–5 shows the maximum peak-to-trough decline of GDP over a business cycle for various countries for various periods, a crude measure of instability. There was more such variability before World War II than since.

[17]Some variation across countries and over time is attributable to variations in labor force participation rates.

FIGURE 2–5 Maximum Peak-to-Trough GDP Decline over Cycle

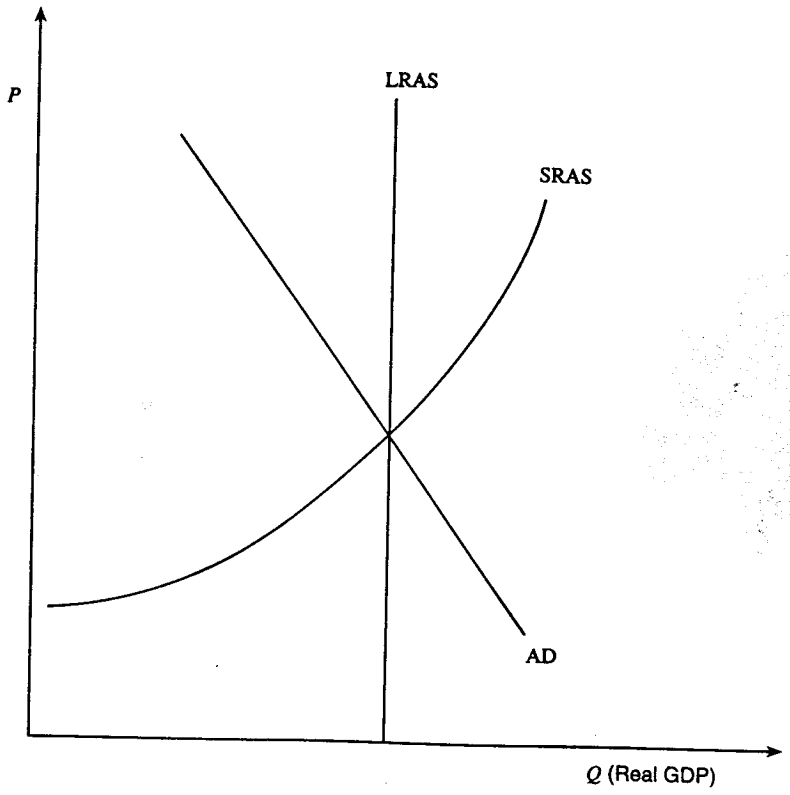


Examination of the components of GDP indicates the most variable element is capital investment, sometimes characterized as a "flighty bird." That capital investment varies considerably can be explained on grounds from exogenous fluctuations in new technologies that can serve as the basis for investment to fluctuations in government monetary policies affecting interest rates to psychological fluctuations of the "animal spirits" of those making investments. The serious question is why these factors lead to fluctuations in the unemployment rate given that in a perfectly competitive labor market wage rates should fall when the demand for labor falls thereby preventing the emergence of any involuntary unemployment. Two broad schools of thought, the *Keynesian* and the *classical* have different answers to this.[18]

The former, deriving its views largely from the British economist J. Maynard Keynes and his *General Theory of Employment, Interest and Money,* argues that rigidities of various sorts exist in labor markets and that capital investment can collapse and stay down for extended periods of time, as in the Great Depression. The implication is that government intervention through fiscal or monetary policies may be advisable to stimulate the economy and to stabilize and smooth out business cycles.

[18]These two schools have various subcategories including old and new classicals and Keynesians, post Keynesians, and supply-siders. To the left and right of this broad division stand the pro–command socialist Marxists and their ideological opposites, the very pro–laissez-faire Austrians.

FIGURE 2–6 Alternative Views of Macroeconomic Equilibrium



The latter, deriving from 19th century classical political economists such as David Ricardo, argues that market capitalist economies have a powerful self-correcting mechanism. Conscious government intervention tends to generate inflation and to aggravate any fluctuations. To minimize unemployment, unions should be broken up and a stable fiscal and monetary environment should be maintained within a laissez-faire environment.

Figure 2–6 depicts alternative views of macroeconomic equilibrium. P now represents the overall price level of the economy and Q represents the aggregate level of real output. Aggregate demand (AD) is downward-sloping. However SRAS represents an upward-sloping, short-run aggregate supply curve as conceptualized by Keynesians. Its shape implies that a decline in aggregate demand will cause a decline in real output and a decline in employment. LRAS represents a long-run aggregate supply curve as conceptualized by classicals. Most classical economists recognize that output can decline in

the short run for a variety of reasons, but argue that *very quickly* a laissez-faire economy will return to behavior depicted by the LRAS. Declines in aggregate demand will lead to declines in the price level rather than in real output or employment.

Tools of Macroeconomic Policy

Two main macroeconomic policy tools are fiscal and monetary policy. Fiscal policy is a nation's budget, its package of spending and tax rates. Generally the higher spending and the lower tax rates, the higher will be the stimulus to aggregate demand. Monetary policy is the expansion or contraction of a nation's money supply and the lowering or raising of interest rates in its economy, each of the first stimulating aggregate demand and each of the second contracting it.

In parliamentary democracies where the executive leaders are the legislative leaders, responsibility for fiscal policy is well defined. In the United States the separation of the executive and legislative branches of government makes for a messier situation. Executive agencies propose spending packages that are filtered through the Office of Management and Budget (OMB), which generally acts as the president's executive arm on spending proposals. The Treasury makes tax proposals. These are combined and submitted to Congress, which chops them up and sends them through a plethora of committees and subcommittees, rarely succeeding in actually passing a complete budget in time for when it is supposed to take effect. Disagreements between Congress and the president then are worked out through negotiation or, in cases with more conflict, through the veto process. What finally emerges and is actually implemented by the executive agencies may not resemble the desired plans of anybody involved.

In all modern market capitalist economies monetary policy is carried out by a central bank that controls the domestic money supply and at least short-term interest rates. The concentration of decision making in one body generally allows a greater degree of purposiveness and control of monetary policy than exists for fiscal policy. It has been argued that the third most powerful person in the world is the Chairman of the Board of Governors of the U.S Federal Reserve System, the U.S. central bank (the "Fed").

Nations vary considerably in how their respective central banks relate to entities in charge of fiscal policy. Some central banks have considerable autonomy and independence, notably the Bundesbank of Germany. Others are subordinated to fiscal policy makers, notably the Bank of England, which is administratively under the control of the budget-proposing Chancellor of the Exchequer. The U.S. Fed is somewhere in between—it was created by and is subject to rules established by Congress, and its Board of Governors is appointed by the president for 14-year terms. It is widely argued that the more independent central banks have had better records at controlling inflation.

A Recapitulation of the Strong Case for Laissez-Faire

A major theme of recent world political economy has been a strong shift towards supporting more laissez-faire. The enormous changes in Eastern Europe have had much to do with this, but so have changes in the market capitalist economies. In the former communist world, disillusionment with the old ideology of command socialism has led to great fascination with its extreme opposite, laissez-faire market capitalism. Even the backlash to this—former communists have won elections in some countries—has been marked by support for market-oriented reforms of one sort or another, if only as promises to take a more gradualistic approach.

There is tension between asserting the efficiency of competitive equilibria and recognizing the limits of the applicability of that theorem. While recognizing these limits the stronger advocates of laissez-faire argue against their significance or relevance.

The most straightforward case is made by the *Chicago School*, whose most prominent and comprehensive spokesman is Milton Friedman.[19] The Chicago School argument draws directly from the efficiency theorem and follows by asserting the irrelevance or unimportance of the various exceptions and limits. It claims that markets are almost always efficient and so government should keep its hands off.

Monopolistic or oligopolistic market structures reflect efficient and competitive behavior by the firms involved, unless they are enforced because of some government restriction on entry. Friedman's opposition to government restrictions on entry leads him to oppose the licensing of doctors by government. Most government-initiated antitrust suits are just a waste of time, distracting firms from their market-appointed task of efficiently providing goods and services to consumers.

Most externalities will be resolved by private markets if property rights are properly defined and enforced, as suggested by the Coase Theorem. If they are not, they are probably not very significant and the benefits to be obtained from any possible government intervention will be more than offset by the inefficiencies and waste associated with government activity it is argued.

Many of the goods provided by the public sector are not really collective consumption goods and could be more efficiently provided privately it is claimed. Thus privatization of public goods provision should be vigorously pursued.

Information costs are inevitable and cannot be avoided. Again, inefficient governments are supposedly unlikely to be very helpful in improving matters in this area.

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[19] A sign of Friedman's special prominence occurred when former Soviet leader Mikhail Gorbachev visited the Hoover Institution at Stanford University, where Friedman was then located. Gorbachev made a special point of seeking him out for praise and a handshake.

In macroeconomics the Chicago School supports the classical approach. Friedman in particular is the most prominent advocate of *monetarism* in the United States and is the father of the proposal that the money supply should grow at a constant rate per year. Beyond that, fiscal policy should involve low-to-no deficits and should not be actively used for stabilization efforts.

With respect to the distribution of income, people should be allowed to keep what they earn from the free market. Inequalities are the necessary outcome of providing sufficient incentives for production, investment, and growth. The equity-efficiency trade-off is real and efficiency should be favored. So government should not redistribute income it is argued.

A more general criticism of government intervention is made by public choice theory, which argues that the government agencies designated to carry out the market-correcting activities are self-interested entities that become captured by special interests operating through their legislative connections.

This analysis became more focused after the discovery of the concept of *rent-seeking* by Anne Krueger, *rent* defined as the return to a factor fixed in supply, such as land or a unique individual. Government agencies can through regulatory actions create artificial scarcities, such as a limited number of import licenses in a less-developed country. Doing so then artificially creates rents that can be captured by special interests or even by the bureaucrats in charge of allocating these scarce items by means of bribery. Large amounts of economic resources become devoted to the creation and capture of these rents, often involving corruption.

Summary and Conclusions

Modern market capitalism evolved out of the merchant capitalism of Northern Italy and Flanders in the late medieval period to reach its closest approach to laissez-faire in the emergence of the industrial revolution in Britain and the United States in the 19th century. These economies have seen increased government intervention in the 20th century, leaving Switzerland and Hong Kong as the most laissez-faire advanced economies in the world today.

A complete, competitive, full-information general equilibrium, in which supply equals demand in all markets, is efficient in the Pareto sense. Thus no individual can be made better off without making some other individual worse off. This theorem does not address the question of income distribution, and critics of market capitalism emphasize its tendency to inequalities of income and wealth, which seem to be worsening over time. Supporters of market capitalism, however, argue that such inequalities are necessary for bringing about economic growth because they provide incentives for work effort and investment.

Box 2–2

Does Rent-Seeking Explain National Destinies?

The rent-seeking theory has been broadly applied by Mancur Olson in his *The Rise and Decline of Nations.* He revives the Jeffersonian notion that every society needs a revolutionary shake-up from time to time in order to maintain its dynamism. Without such occasional shake-ups, often brought about by defeat or conquest by a foreign power, interest groups accumulate power and influence and are able to expand their rent-seeking activities to the point that the economy loses all ability to change or grow as it becomes encrusted with more and more regulations and restrictions designed to protect the increasingly bloated rents of the outdated special interests. He presents the stagnation of never-conquered-since-1066 Great Britain and its ossified class system as a leading negative example and the postwar economic dynamism of defeated Germany and Japan as positive examples. The Olson theory suggests that Russia and her former allies may have bright futures if they can get through their difficult transitions.

The efficiency theorem suggests that a minimal government, laissez-faire economy might be inefficient because of monopoly power, externalities, insufficient public goods, imperfect information, and possible macroeconomic instability. During the 20th century the U.S. economy has developed mechanisms for dealing with these problems, many of which involve some sort of government activity or intervention although much of this has been questioned in the United States since the 1994 election.

Despite this evolution, controversy and debate continue regarding the appropriate scope of government involvement in mixed market capitalist economies. Strong supporters of laissez-faire critique proposed and actual ways in which governments seek to correct the inefficiencies of unfettered markets. This suggests that as the former socialist countries continue to move towards market capitalism they will increasingly encounter serious questions regarding the ultimate balance between the public and private sectors within their economies.

Although the United States is much closer to laissez-faire than most market capitalist economies, its government actively intervenes in a variety of ways to deal with the above problems. A recent trend has been towards policies that may involve establishing a market where none existed before, for example for tradeable pollution permits. Compared with other market capitalist economies, the United States has a very high real income, high level of

competitiveness, greater income inequality, weaker unions, more per capita air pollution, a smaller public sector, and historically somewhat greater volatility of its GDP. Thus it shows both the dynamism but also the difficulties of market capitalism as a system.

Questions for Discussion

1. "Income inequality is necessary for Pareto optimality so that people will work as hard as they can." "If income is distributed equally then there must be Pareto optimality because you can't make one person better off without making someone else worse off." Are these statements true or false? Why or why not?
2. How does the U.S. economy compare with other market capitalist economies with respect to its degree of industrial concentration and the nature of its antitrust policies?
3. Socialist critics of market capitalism argue that businesspeople will not care about the environment because they are only concerned about profits whereas socialist planning will be able to take care of the environment. Why then have environmental conditions generally been better in the industrialized market capitalist economies than in the industrialized command socialist ones?
4. What are some goods that are publicly provided in the United States that could be efficiently provided privately instead? Why are they not so provided?
5. Looking at the tables in this chapter, can you find any evidence that the influence of Keynes might have contributed to improved macroeconomic performance among market capitalist economies? How might his influence have failed to improve their performance?
6. How might you critique the "strong case for laissez-faire" presented at the end of the chapter?

Suggested Further Readings

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